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Supreme Court of the United States

OCTOBER TERM, 1961.

No. 603

MILWAUKEE & SUBURBAN TRANSPORT CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

Milwaukee & Suburban Transport Corporation petitions for a writ of certiorari to review the judgment of the Court of Appeals for the Seventh Circuit in this case.

PREVIOUS PROCEEDINGS AND OPINIONS.

The memorandum opinion of the Tax Court, T. C. Memo 1959-216, (pp. 256-286 of the Appendix Record printed for the use of the Court below and filed herewith) is not officially reported. The original opinion of the Court of Appeals (Appendix A, *infra*, pp. 23-40) is reported at 283 F. 2d 279.

The per curiam decision of this Court vacating the Judgment and remanding the case (Appendix B, *infra*, pp. 42-43) is reported at 367 U. S. 906. On September 12, 1961

the United States Court of Appeals for the Seventh Circuit without further opinion, entered an order (Appendix C, *infra*, pp. 44-45) stating that its previous mandate was recalled, its previous Judgment vacated, and the decision of the Tax Court affirmed.

JURISDICTION.

The current Judgment of the Court of Appeals was entered September 12, 1961 (Appendix C, *infra*, pp. 44-45). A petition for rehearing, timely filed, was denied on October 4, 1961. The jurisdiction of this Court is invoked under 28 U. S. C. Sec. 1254(1).

QUESTION PRESENTED.

The taxpayer, a municipal transit company filing its federal income tax returns on an accrual basis, regularly employs in keeping its books a generally accepted method of accounting, standard in its industry, which involves accruing each year the estimated amount of incurred liability for injuries and damages arising out of accidents which occurred that year. As claims are disposed of in subsequent years any net difference between estimated and settled liability is taken into account in the year of disposition.

The Circuit Court of Appeals in its decision quoted with approval the statement of the question set out by the Tax Court. It is as follows:

> "The question here presented is whether petitioner, an accrual basis taxpayer, may deduct for each of the years 1953 and 1954, certain amounts accrued by it on its books of account as of December 31 of each year. Such amounts represented its estimate of the probable amounts which it would have to pay in settlement for personal injuries and property damages, arising out of accidents in which its employees and equipment were involved."

STATUTES AND REGULATIONS INVOLVED.

The pertinent provisions of Sections 41, 42 and 43 of the Internal Revenue Code of 1939, of Sections 446 and 461 of the Internal Revenue Code of 1954, of Sections 39.41-1, 39.41-2, 39.42-1, 39.43-1 and 39.43-2 of Treasury Regulations 118 (1939 Code) and of Sections 1.446-1 and 1.461-1 of Treasury Regulations on Income Tax (1954 Code) are reprinted in Appendix D, *infra*, pp. 46-53.

STATEMENT.

This case was previously before this Court as No. 843, October Term, 1960, on petition for certiorari by the government. One other case also involving the accounting method sections of the Internal Revenue Code, although quite different in its facts, *Commissioner* v. *Schlude*, No. 629 (below, C. A. 8, 283 F. 2d 234) was also so pending when on June 19, 1961 this Court entered its decision in *American Automobile Association* v. *United States*, No. 288, October Term, 1960. In connection with its decision in the *American Automobile* case, this Court entered orders granting the government's petitions for certiorari in this case and *Schlude* and without briefs or arguments on the merits vacated the decisions and remanded them to the respective Courts of Appeals "in light of" the *American Automobile* decision and, in this case, also "in light of" *United States* v. *Consolidated Edison Company of New York, Inc.*, No. 357, October Term, 1960.

This taxpayer read this Court's order "vacating" the previous decisions in this case and *Schlude* as not intimating any opinion as to the merits of either case but rather as simply directing the respective Courts of Appeals to reexamine their previous decisions "in light of" the two accounting method cases which this Court had just decided

during the same term. We therefore filed no petition for rehearing with this Court. In *Schlude*, taxpayers were more disturbed by the exact wording of this Court's order and filed a petition for rehearing. On October 9, 1961, this Court denied that petition but modified its original order by adding the words "for further consideration".

In this case, it now appears that the Court of Appeals—contrary to our expectation—did consider that "vacated and * * * remanded in light of" did mean something different than "vacated and * * * remanded for further consideration in light of", since on September 12, 1961, without opinion, it entered its order (Appendix C, *infra* pp. 44-45) reversing its previous judgment.

The result is that the last *opinion* in this case (Appendix A, *infra*, pp. 23-40) is favorable to taxpayer but the last *judgment* (Appendix C, *infra*, pp. 44-45) is unfavorable, without any discussion either by the Court below or by this Court in explanation of the result.

Because the basic facts are fully set forth in the proceedings in No. 843, October Term, 1960, to which reference is made, we restate them here only in summary form.

The taxpayer, a Wisconsin corporation, operates the metropolitan transit system in and around Milwaukee, which it acquired by purchase of assets on December 30, 1952. It files its returns on a calendar year and accrual basis. During 1953 and 1954, the years in controversy, it operated approximately 1,000 vehicles, carrying from 250 to 281 million passengers annually. Its vehicles were involved in slightly more than 5,000 accidents each year. (Appendix A, *infra*, p. 31.)

So far as here material, taxpayer was a self-insurer of its accident liabilities. It maintained a staff of attorneys and claims adjusters to investigate, settle and defend claims for personal injuries and property damages. Most

accident claims were settled in the year in which they occurred but as of the end of each of the years in controversy there were slightly more than 400 unsettled claims from accidents which had occurred in that year. (Appendix A, *infra*, p. 32.)

In order to know the true results of its operations for each particular year, taxpayer had to take into account its total liability for accidents which occurred in that year, including those unsettled as well as those settled. At the end of each year it therefore appointed a committee of three of its directors, two of whom were lawyers, who, with its claims department, examined each unsettled claim and appraised the amount of its liability. This amount was $254,659 for 1953 and $161,136.50 for 1954. These amounts were deducted as expenses and recorded as accrued liabilities by taxpayer in determining the results of its operations for each year. (Appendix A, *infra*, p. 32.)

As payments were made in future years in settlements of these liabilities, the amount thereof was charged to the accrued liability and was not charged to expense in the year of settlement. Accidents were considered settled when agreement was reached with the injured person, or upon conclusion of any litigation, or if no claim was filed within the two year statute of limitations applicable under local law. Any net difference between liability as appraised and as finally determined was reflected in book and taxable income in the year of settlement.[1]

This method of accounting for an urban transit company's liabilities for injuries and damages unsettled at the close of the year in which the accidents occur is in accordance with generally accepted principles of accrual account-

1 This is the normal method of adjusting accruals as specifically required and authorized by Treasury Regulations Sec. 1.461-1 (a) (2).

ing, has been consistently applied by the taxpayer since it first commenced business and is the recognized and accepted method of accounting for such liabilities in the transit industry.

In filing its federal income tax returns taxpayer accounted for its injuries and damages liabilities unsettled at the close of the year in which the accident occurred in accordance with the same method which it used to compute its income in keeping its books. The resulting deductions were $254,659 for 1953 and $142,022.87 for 1954, the latter figure computed as follows (Appendix A, *infra*, p. 33):

Appraised liability on unsettled claims, 1954 accidents	$161,136.50
Deduct: Adjustment for 1953 claims settled in 1954	19,113.63
Net amount expensed and added to liability account, 1954	$142,022.87

As of the time of trial, there remained 8 unsettled 1953 claims, liability on which was currently estimated at $14,500, the original estimate having been $5200. In addition, there were 13 unsettled 1954 claims currently estimated at $51,415 and originally estimated at $12,750. (Appendix A, *infra*, p. 34.)

The Commissioner disallowed the entire amount of $254,659 deducted by taxpayer in 1953 and $61,472.79 of the $142,022.87 deducted by taxpayer in 1954 under its method of accounting for these liabilities. The Commissioner allowed as a deduction only the amount of these claims which were actually settled or paid in each year, namely, none in 1953 and $80,530.08 in 1954. (Appendix A, *infra*, p. 33.)

Viewing each claim separately, taxpayer's estimates of liability varied from the liability finally determined. How-

ever, viewed in the aggregate, taxpayer's actual liability (actual settlements plus currently revised estimates of the few remaining unsettled claims) compares with the deduction claimed by taxpayer under its method of accounting and with the deduction allowed by the Commissioner as follows:

		Taxpayer's Deduction		Commissioner's Deduction	
	Actual Liability	Amount	% to Actual	Amount	% to Actual
1953	$196,230.24	$254,659.00	130%	—0—	00%
1954	212,266.84	142,022.87	67%	$80,550.08[2]	38%
	$408,497.08	$396,681.87	97%	$80,550.08	20%

[2] The difference between the 1954 settlements of 1953 cases ($75,780.37) and the deduction allowed by the Commissioner ($80,550.08) is not explained by the record. It is apparently attributable to payments in 1954 in partial satisfaction of liability on 1953 accidents (medical expenses, etc.) in cases where total liability was not settled until a later year.

A comparison of the accuracy of the taxpayer's method with that contended for by the Commissioner thus indicates that while the taxpayer's method results in a determination which was 97% of the final determination, the Commissioner's method results in a determination which is only 20% correct when measured against the final liability.

The Tax Court sustained the Commissioner. The Court of Appeals reversed. This Court vacated. The Court of Appeals then entered a new order affirming the Tax Court.

REASONS FOR GRANTING THE WRIT.

This case, in its present tortured posture, demands for several reasons the exercise of this Court's certiorari jurisdiction.

1. The action of the Court of Appeals herein in summararily reversing, without opinion, its previous well-considered decision because of the mandate of this Court herein, when coupled with the clarification which this Court has subsequently given to its similar mandate in *Schlude*, demonstrates the distinct probability that the Court of Appeals has misinterpreted the mandate of this Court. This can now only be corrected by the grant of this petition for certiorari.

2. It is manifest injustice, amounting to a clear departure from the accepted and usual course of judicial procedure, to have any case disposed of on the basis of an opinion favorable to one party and judgment in favor of the other with no suggestion as to wherein, if at all, the opinion was in error. It is perfectly clear that this Court on June 19, 1961, was not reviewing this case or *Schlude* on the merits and was certainly not deciding that either of them or both were ruled by the two other accounting method cases which it had decided during the same term. Certainly nothing of the kind was said by this Court. The September 12, 1961 order of the court below makes it equally clear that it was not holding that this case was ruled by *American Automobile Association* or *Consolidated Edison Company;* neither did it withdraw anything which it had said in its previous opinion. Yet, for no apparent reason (unless it be that it read into the mandate of this Court an unexpressed desire that it should reverse), it reversed, without explanation, its judgment based upon its carefully considered opinion. Such a course is certainly a startling

departure from the accepted and usual course of judicial proceedings.

3. Neither the *American Automobile Association* decision nor the *Consolidated Edison* decision is applicable to the factual or legal questions in this case; the Court of Appeals should have re-entered its prior opinion and judgment. Those cases simply confirm what this Court has said in previous cases with respect to the income tax treatment of deferred income and the meaning of the term "payment." This case is concerned with the question of the *timing* of the accrual of an *existing* liability and can in no way be governed by principles applicable to deferred income or the meaning of payment.

The specific questions here presented are whether: (a) petitioner's method of accounting for its accrued injuries and damages liability "clearly reflects" its annual income; (b) whether all events which determine liability had occurred during the tax year; and, (c) whether the taxpayer determined the amount of such liability with reasonable certainty.

The Court of Appeals has found specifically that petitioner's method of accounting "does clearly reflect its income on an annual basis" (Appendix A, *infra*, p. 35), that all events which determine liability had occurred during the tax year (Appendix A, *infra*, p. 36), and that the petitioner determined the amount of such liability with reasonable certainty. (Appendix A, *infra*, p. 39.) Its current judgment in no way changes these findings.

The Court of Appeals finds that petitioner's method of accounting clearly reflects its income. In *American Automobile Association*, this Court agreed with the Commissioner and the Court of Claims (which had twice refused to make a contrary finding) that the taxpayer's method of accounting did *not* clearly reflect its income. In fact, this

Court found that the method there followed was artificial and that it had no relation to the expenses against which the income was sought to be deferred. There, the taxpayer was seeking to defer income to cover future events which might or might not occur.[1] Since these were merely probable future events which had not actually occurred (*i.e.*, members' call for service) current income could not be deferred, just as a reserve for future events, however probable, cannot be currently deducted. Here, the petitioner is seeking only to accrue an expense for actual events which have *already* occurred. This important distinction between reserving for or deferring income for probable future liabilities and accruing for liabilities already incurred has long been recognized by this Court, (see: *Brown* v. *Helvering*, 291 U. S. 193, in contrast with *U. S.* v. *Anderson*, 269 U. S. 422). In fact, this distinction between reserving for probable future liabilities and accruing for liabilities already incurred is precisely the distinction relied upon by this Court in footnote 4 of its *American Automobile Association* opinion (367 U. S. 687, 691). Properly accruing for incurred liabilities will clearly reflect income. Reserving for future events or deferring income to cover future events will not (except in certain situations specifically provided for by statute) clearly reflect income. These two different situations are, however, totally unrelated and one does not control the other. Thus, the finding that petitioner clearly reflected its income in this case is in no way controlled by the *American Automobile* decision on this issue.

The Court of Appeals further found that all events

1. This is no different than a landlord even on an accrual basis who must report prepaid rent as income when received despite his future obligations. *Mertens: Law of Federal Income Tax*, Vol. 2, sec. 1230, p. 111

which determine liability had occurred during the tax year and that the taxpayer had determined the amount of such liability with reasonable certainty. The court felt, and rightly so, that under the "all events" test these facts must be found before an accrual becomes deductible for tax purposes. As the court stated (Appendix A, *infra*, pp. 36, 39):

> "While an expense may be logically related to one year or another, it is true that to be deductible as an accrual all events which establish a definite liability in the taxpayer must have occurred during the taxable year, and the amount of such liability must be determinable with reasonable certainty. *Dixie Pine Products Co. v. Commissioner of Internal Revenue*, 320 U. S. 516 (1944); *United States v. Anderson*, 269 U. S. 422 (1926). In the instant case, the court feels that these tests have been met by the petitioner.
>
> "The petitioner argues, and rightly so, that all events which determine liability have occurred."
>
> . . . . .
>
> "Under the circumstances of this case, the court is of the opinion that a reasonably certain estimate was made with due regard for the actual facts and conditions underlying each claim."

These factual issues were not involved in either *American Automobile* or *Consolidated Edison*. *American Automobile* was decided primarily on the question of clear reflection of income. There, the artificial accounting convention totally unrelated to occurred events prevented, in this Court's opinion, a clear reflection of income. The "all events" test, which relates to the deductibility of expenses and not the determination of income, was not in any way in issue in that case. By agreement of all concerned, *Consolidated Edison* dealt solely with "the very narrow issue [of] whether the remittance admitted liability for, and constituted 'payment' and 'satisfaction' of, the con-

tested part of the assessment and thereby rendered it accruable in the year of the remittance " 366 U. S. 380, 387. In other words, it involved only the meaning of the term "payment" under the Internal Revenue Code. No broader questions were presented or discussed.

The opinion in *Consolidated Edison* does set forth the "all events" test and the so-called "refinement" thereto, and reaffirms the Court's prior decisions in *U. S. v. Anderson*, 269 U. S. 422 (1926), *Dixie Pine Products Co. v. Commissioner*, 320 U. S. 516 (1944) and *Security Flour Mills Co. v. Commissioner*, 321 U. S. 281 (1944). The taxpayer and the Government in *Consolidated Edison* agreed and *stipulated* that the accrual contended for by the Commissioner would not be otherwise accruable except for the alleged payment of the item by the taxpayer. The issue was thus narrowed to the question of what constituted payment. As far as any questions of fact or questions of law concerning the "all events" test are concerned, the *Consolidated Edison* case merely reaffirmed the tests previously laid down by this Court. The legal question here involved was not there decided. The sole question of law in this case is whether the so-called "refinement" to the "all events" test, *i.e.* that an accrual for a single, contested, litigated claim is not deductible, defeats the deductibility of the accrual here in question. The Court of Appeals here recognized this "refinement" to the all events test, but, in its opinion, held it to be inapplicable to the facts of this case. The court distinguished the *Dixie Pine* and *Security Mills Co.* cases and followed the sound reasoning of the Second Circuit in *Ocean Accident & G. Corp. v. Commissioner*, 47 Fed. 2d 582, (see section 4 below).

We thus have a situation where the present judgment of the Court of Appeals is directly and irreconcilably in conflict with its own findings and is apparently based upon

two decisions which are totally unrelated to the questions here presented.

4. Further, the petition for certiorari should be granted because the unexplained decision below (A) is plainly incorrect, (B) is in direct and irreconcilable conflict with a decision of the Court of Appeals of the Second Circuit which this Court has cited with approval and (C) is in conflict with the announced principles of several other decisions of this and other courts.

A. Fundamentally, the instant decision is wrong because it violates the basic principle of computing income according to annual accounting periods. The liabilities here in question are for accidents which occurred during the year. At the close of the year all of the events which are relevant to a determination of the fact or amount of liability have already occurred. As stated by the court below (Appendix A, *infra*, p. 36):

> "... all events which determine liability have occurred. The accidents out of which the various claims grow undoubtedly have occurred in the years in question, and the physical facts of the accidents are the only events upon which liability is predicated."

The facts are fixed; nothing thereafter will change them. If this taxpayer were to go out of business (as did its predecessor) both the fact and amount of these liabilities would remain immutable. Nothing could be more misleading or artificial than to compute the income of the year without taking these liabilities into account.

The year of settlement of any individual case, however, is wholly fortuitous and certainly "artificial" in the sense that it is unrelated to the actual events which occur in the operation of the business. Such factors as the fluctuating state of the dockets of courts trying personal injuries matters, the opinions and practices of a particular attorney

representing a claimant as to the most auspicious time for settlement, and even such factors as the taxpayer's temporary cash position (and its consequent disposition to speed or delay settlement) tend to determine the year in which a particular individual claim is settled. In the end, over a period of six or eight years, the amount deducted is the same under either system. Taxpayer's method accrues the liability in the year in which occurred all of the events which give rise to it. The Commissioner's method places the deduction in some later year in which extraneous circumstances result in final settlement of each individual claim. Far from being a more clear reflection of income on an annual basis, the Commissioner's method results in a severe distortion not only of the income of the year in which the accident occurred but also of the year of settlement since there is no relationship whatsoever between the operations of that later year and the liability settled.

B. The present decision is directly in conflict with the decision of Judges L. Hand, Swan and A. N. Hand of the Court of Appeals for the Second Circuit which has been approved by this Court: *Ocean Accident v. Commissioner*, 47 F. 2d 582, cited with approval in *Brown v. Helvering*, 291 U. S. 193, 200, along with *U. S. v. Anderson*, 269 U. S. 422. Throughout these proceedings the government has attempted to distinguish *Ocean Accident*, followed by the court below in its opinion, by implying (here) or stating (below) that the question there turned on special statutes applicable only to insurance companies. We have repeatedly demonstrated that, like the instant case, *Ocean Accident* was not concerned with *what* was deductible but solely with *when* and that the decision there did not turn on any of the special provisions applicable to insurance companies but rather on the definition of "accrued" then, as now, applicable to all taxpayers. Further discussion on this point

may be found at page 8, note 4, and pages 18-19 of our Brief in Opposition in No. 843, October Term, 1960.

C. Finally, the present decision is in conflict with the principles of numerous cases of this and other courts. The clearest conflict with decisions of this Court is with *U. S. v. Anderson*, 269 U. S. 422. The question in *Anderson* was whether an accrual basis taxpayer ought to deduct its 1916 munitions tax in 1916, as the Government there contended, or in 1917 when it was settled and paid. In deciding for deduction in the earlier year, this Court laid down the famous "all events" test.

> "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and become due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books." (269 U. S. 422, 441.)

It was perfectly clear in the context of the case that this Court was there talking about a situation in which the operative facts have actually occurred although their meaning or even existence may be subject to future argument; that it is *not* required that the ultimate *determination* of liability shall have occurred; that what *is* required is that all the *events* shall have occurred *from which* the liability is determined.

> "By the close of the year, liability for the tax had become definitely fixed, the tax being based on the result of operations for 1916 * * * neither liability for the tax nor the amount properly payable could be affected under the law by anything occurring after December 31, 1916. * * * The fact that a difference of

opinion might arise after December 31, 1916, between the taxpayer and the Commissioner of Internal Revenue as to what was a reasonable depreciation on plant and equipment, or as to other items of that nature, did not provide new factors occurring after December 31, 1916, varying the tax." 269 U. S. 422, 425-426 (Argument for the United States).

"A consideration of the difficulties involved in the preparation of an income account on a strict basis of receipts and disbursements * * * indicates with no uncertainty the purpose of Sections 12(a) and 13(d) [Sec. 446, 1954 Code] * * * to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period * * *

"The appellee's true income * * * could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year." 269 U. S. 422, 440 (Opinion of the Court).

As applied to the facts of the present case, the Court below stated (Appendix A, *infra*, p. 36):

"In this case then, we have a situation where the operative facts have actually occurred although their meaning or even existence are subject to argument. This is in contrast to the situation where the operative facts have not occurred but are highly predictable. In the latter situation, many businesses prudently set up reserves to protect themselves, but they are not deductible as accrued expenses for although intimately related to the income of the earlier year, the events which fix liability have not happened. This is true even though the future expenses are predictable with great accuracy. *Brown* v. *Helvering*, 291 U. S. 193 (1934). In the instant case, the expense is related to the income of the earlier year, and the operative facts upon which liability is dependent have occurred."

That the crucial question is the occurrence of the *events* which determine liability, not the determination itself, accords with the Government's own historical and never revoked position, *I. T. 2500*, VIII-2 CB 103 (1929), and has recently been expressly reaffirmed by this Court, *Lewyt Corp.* v. *Commissioner*, 349 U. S. 237, 243.

In addition to the direct conflict with the Court of Appeals for the Second Circuit, among the decisions of the other Courts of Appeals with which the present decision of this case is in conflict is *Schuessler* v. *Commissioner*, 230 F. 2d 722 (C. A. 5), which was specifically distinguished by this Court in *American Automobile Association* v. *U. S.*, 367 U. S. 687, 691, Note 4, and *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180, 189, Note 20. Similarly as to *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (C. A. 10). So also with *Harrold* v. *Commissioner*, 192 F. 2d 1002 (C. A. 4); *Denise Coal Co.* v. *Commissioner*, 271 F. 2d 930 (C. A. 3); *Hilinski* v. *Commissioner*, 237 F. 2d 703 (C. A. 6); *Pacific Grape Products Co.* v. *Commissioner*, 219 F. 2d 862 (C. A. 9).

5. Finally, the Petition for Certiorari should be granted because the factual situation presented here is at once significantly different from, while yet superficially similar to, the factual situations presented in *American Automobile Association* and in *Consolidated Edison*, and this case therefore presents an unusual opportunity for a decision by this Court which will furnish important and needed guidance to all of the lower courts by laying to rest the uncertainty and speculation which has arisen out of some of the language used in but not necessary to the decision of the *American Automobile* relating to the Commissioner's discretion in matters involving the clear reflection of income. This is particularly important because of the fact that the result in the *American Automobile* case was so promptly reversed

by action of Congress (Public Law 87-109). Since further interpretation of the *American Automobile* decision on closely related facts is now precluded, it is of the utmost importance to the lower courts and to taxpayers—and should be of utmost importance to the Internal Revenue Service—that the applicability, if any, of the *American Automobile* decision to dissimilar fact situations be explained promptly by this Court.

The basic statute governing methods of accounting acceptable for income tax purposes (Sec. 446) states as the general rule that "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." (Appendix D, *infra*, p. 49.) Nothing is said here about any discretion of the Commissioner. Then follow two exceptions, four specifically permissible methods and specific rules for two special situations (more than one business and change in method). Of the two exceptions, one deals with the situation where no method of accounting has been regularly used. This has presented little difficulty. The second exception is the source of practically all of the litigation which has arisen:

> "* * * if the method [of accounting] used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate does clearly reflect income." (Appendix D, *infra*, p. 50.)

According to the plain terms of the statute, the discretion or "opinion" of the Secretary or his delegate does not come into play unless and until it is first determined that the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books does not clearly reflect income. True, in the course of dispute and litigation, the initial determination of whether or not a particular method clearly reflects income will be made by the Commissioner and in court the burden will be on the tax-

payer to show that the determination was wrong; but it has always been considered that this involves no more than the ordinary burden of proof of establishing any point of fact or law; that it did not involve the much more difficult burden of establishing an abuse of discretion.

At least heretofore, it has been considered as flowing from the plain language of the statute that the Commissioner's statutory power to change a taxpayer's method of computing income exists only if the method employed does not clearly reflect income, *Huntington Securities Corporation* v. *Busey* (C. A. 6, 1940), 112 F. 2d 368; *John J. Harden* v. *Commissioner* (C. A. 10, 1955), 223 F. 2d 418; that in order to prevail, a taxpayer need only establish that the Commissioner improperly asserts that the method used did not "clearly reflect" his income. *Helvering* v. *Taylor*, 293 U. S. 507, 515 (1935). There has been a sharp distinction between such a situation and the quite different case where a taxpayer has sought to change his method of accounting and is therefore subject to the Commissioner's "wide discretion" to reject such a change. *Brown* v. *Helvering*, 291 U. S. 193, 204 (1934).

There is language in the opinion in the *American Automobile Association* case, however, 367 U. S. 687, 688-689 which suggests that the Commissioner's discretion extends not merely to determining what method of accounting is to be used if the method used by the taxpayer does not clearly reflect income, but also extends to the initial determination of whether the method actually used does or does not clearly reflect income. Inasmuch as the opinion then goes on to examine the method there employed by the taxpayer to test its reflection of income as a matter of law, rather than as a matter of reviewing for abuse a discretionary decision of the Commissioner, it is probable that the language used was not intended as a holding that the question of whether a method which was used does or does not clearly reflect

income is a matter for the discretion of the Commissioner. Such a holding would not only read into the statute a phrase which is not there, it would completely abolish the general rule which is stated in the statute and destroy the statutory distinction between those situations in which the Commissioner does and does not have a discretion to impose a method of accounting of his own choosing.

This language of the *American Automobile Association* opinion has nevertheless suggested to nearly all the readers of that decision that this Court was perhaps converting into a matter for the Commissioner's "discretion" the basic question of whether a method of accounting regularly employed by a taxpayer does or does not clearly reflect income. Under the statute, the Commissioner has no "discretion" if the taxpayer's method clearly reflects income.

The applicability of the *American Automobile Association* decision to distinguishable factual situations is further clouded by the heavy reliance of that decision upon legislative history most of which—but not quite all—was concerned directly with prepaid dues income, 367 U. S. 687, 694-697. Here again, the reversal by Congress of the result of the *American Automobile Association* decision makes it more imperative that this Court clarify what, if anything, is the applicability of the meaning of that decision to different fact situations.

By no means the least of the questions arising out of the opinion of this Court in *American Automobile Association* which ought now to be settled—and for the settlement of which this case presents a uniquely appropriate vehicle—is the extent to which its holding is limited by the now famous footnote 4 (367 U. S. 687, 691, Note 4) which states that *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697, and *Schuessler* v. *Commissioner*, 230 F. 2d 722, may be distinguished "on the same grounds which made them distinguishable in *Automobile Club of Michigan* v. *Commissioner*,

353 U. S. 180, 189, Note 20." In neither of the *Automobile* cases, however, was the nature of the distinction expressly stated. The apparent distinction, however, is that both of these cases, *like the instant case*, involved an appraisal of events which had already occurred rather than, as in the *Automobile* cases, of future events. *Beacon Publishing Co.*, it may be noted, was decided before the repeal of Sections 452 and 462 and was cited with approval in the Congressional Report which accompanied the repeal. S. Rep. No. 372, 84th Cong., 1st Sess. 5-6; H. R. Rep. No. 293, 84th Cong., 1st Sess. 4-5.

Because the method of accounting herein involved was an approved standard method of accounting which this taxpayer had consistently used without change in keeping its books, because this case involves accrued deductions rather than prepaid income, because this case does not involve the pointed legislative history which weighed so heavily in *American Automobile Association*, and because this case involves the very type of fact situation (appraisal of events which have actually already occurred) which this court apparently distinguished in the *Automobile Association* case, this case furnishes an unusually fine opportunity for much needed clarification of the scope of the *Automobile Club* decisions.

CONCLUSION.

Contrary to the true meaning of the previous mandate of this Court (a meaning subsequently made explicit by amendment of a similar mandate in the companion *Schlude* case) the court below obviously considered the mandate a direction to reverse; it did reverse without explanation other than a recitation of the mandate. Upon examination, neither of the cases cited in the mandate are sufficiently similar to this one so as to control it. To allow this case to be terminated by a judgment which is directly contrary

to the most recent opinion on the merits would be to sanction a severe departure from the accepted and usual course of judicial proceedings. Moreover—and wholly apart from the obvious error and injustice of the present judgment—this case presents an unusually excellent opportunity for clarification by this Court of the applicability of its decision in *American Automobile Association* v. *U. S.*, 367 U. S. 687, to factual and legal situations which are squarely covered neither by that case nor by the subsequent Congressional reversal of the effect of that case as to the fact situation which was there involved. For all of these reasons, this case merits review.

Respectfully submitted,

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Counsel for Petitioner.

December 7, 1961.

APPENDIX A.

IN THE UNITED STATES COURT OF APPEALS
For the Seventh Circuit.

September Term and Session, 1960.

No. 13025.

MILWAUKEE & SUBURBAN TRANSPORT CORPORATION,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REVIEW OF DECISION OF THE TAX COURT OF THE UNITED STATES.

October 24, 1960.

Before DUFFY and KNOCH, *Circuit Judges*, and GRUBB, *District Judge*.

GRUBB, *District Judge*. This is a petition for review of a decision by the tax court disallowing certain deductions by the petitioner in the years 1953 and 1954. There are two issues, one involving the preferred stock of the petitioner and the other involving its accounting method.

Preferred Stock Issue.

Petitioner is a corporation organized on October 7, 1952, under the laws of the State of Wisconsin. It filed its returns for the taxable years 1953 and 1954 with the Director of Internal Revenue for the District of Wisconsin. It kept its books of account and filed its Federal income tax returns in accordance with an accrual method of accounting and on the basis of calendar years.

In the year 1952 and for several years prior thereto, the public passenger transportation system in the City of Milwaukee and its environs was owned and operated by the Milwaukee Electric Railway and Transport Company (hereinafter called the "Transport Company") which was a wholly owned subsidiary of the Wisconsin Electric Power Company (hereinafter called the "Power Company"). Both the parent and the subsidiary were Wisconsin corporations, and the parent also was a registered public utility holding company subject to the provisions of the Federal Public Utility Holding Company Act of 1935 (Title 15 U. S. C., Section 79).

During the 1940's the management of the Power Company and of the Transport Company came to realize that by reason of the provisions of the Public Utility Holding Company Act of 1935, it would be necessary to remove the public passenger transportation properties owned by the subsidiary Transport Company from the holding company system of the parent Power Company.

On December 30, 1952, the petitioner purchased the transportation facilities of the Transport Company. The purchase price of $10,000,000 was payable in the following manner: $4,000,000 in cash to be raised by the sale of bonds to outside parties which would be secured by a first mortgage on the assets; $3,000,000 of the petitioner's promissory notes to be issued to the Transport Company and

which were secured by a second mortgage; and $3,000,000 in preferred stock to be issued to the Transport Company. In addition, the organizers of the petitioner were to invest a total of $500,000 in common stock of the petitioner in order to supply working capital.

The tax court found as fact that :

> "* * * it was the belief of the parties that, if the issuance of the securities by the purchasing corporation was to receive the required approval of the Public Service Commission of Wisconsin (hereinafter called the P.S.C.), the ratio of corporate debt to equity capital could not be too high. Also it was believed that, if the sale was to receive the required approval of the United States Securities and Exchange Commission (hereinafter called the S.E.C.), as a divestiture by the Power Company of the public passenger transportation properties, the preferred stock would have to contain redemption provisions so that any retention of an ownership interest would be of a temporary rather than a permanent nature."

The material provisions of the purchase contract follow:

> "SECTION 2. * * *
>
> "The base purchase price [of $10,000,000] to be paid by the Purchaser to the Seller at the closing shall be as follows:
>
> "(a) $4,000,000 in cash;
>
> "(b) $3,000,000 principal amount of the Purchaser's 5% Secured Promissory Notes, secured by a second mortgage covering the Purchaser's bondable transportation property, * * *; and
>
> "(c) 30,000 shares of the Purchaser's 5% Cumulative Preferred Stock, fully paid and nonassessable, having a par value of $100 per share, * * *.
>
> * * * * *
>
> "The Seller represents that it has no present intention of disposing of the 5% Secured Promissory

Notes and the 5% Cumulative Preferred Stock of the Purchaser to be received by it under this Agreement, except to an associate company in the same holding company system, which will in turn acquire such securities with a view to holding them as an investment and not with a view to distribution.

"SECTION 3. The purchaser agrees that prior to the closing it will issue and sell for cash at not less than the par or stated value thereof, Common Stock having a total par or stated value of at least Five Hundred Thousand Dollars ($500,000).

* * * * *

"SECTION 6. * * *

"(b) The obligation of the Seller hereunder to convey the property to be sold hereunder is subject to the following conditions precedent:

"1. That * * * counsel for the Purchaser shall have given an opinion to the Seller * * * that the 30,000 shares of 5% Cumulative Preferred Stock of the Purchaser to be delivered to the Seller * * * are validly issued, fully paid and non-assessable.

* * * * *

"SECTION 7. This agreement is made subject to obtaining all consents, authorizations and orders which shall be required by law to be obtained from any regulatory authority in order to carry out the terms of this Agreement, which each of the parties hereto agrees forthwith to apply for and to prosecute with due diligence; * * *."

Article III(a) of the petitioner's amended articles of incorporation provides as follows:

"(a) The capital stock of the corporation shall consist of 30,000 shares of Cumulative Preferred Stock of the par value of $100 each (hereinafter called 'Preferred Stock') and 500,000 shares of Common Stock of the par value of $1.00 each (hereinafter called 'Common Stock')."

The preferred stock certificate contained the following provisions:

"(B) The holders of the preferred stock shall be entitled to receive, when and as declared by the board of directors, out of surplus or net profits, cumulative dividends in cash at the rate of 5% per annum and no more, payable quarter-yearly * * *. Such dividends on the preferred stock shall be cumulative from and after the 30th day of December, 1952.

"(C) The corporation, at the option of the board of directors, may redeem the preferred stock at the time outstanding, in whole at any time or in part from time to time, upon notice duly given as hereinafter specified, by paying therefor in cash the par value thereof, together with a sum equal to 5% per annum on the par value thereof from the 30th day of December, 1952 to the date fixed for redemption, less the aggregate amount of all dividends theretofore paid thereon. * * *

"(D) So long as any shares of the preferred stock remain outstanding, there shall be set aside [annually] as a sinking fund for the retirement of preferred stock, [beginning on a date 15 months after the first mortgage bonds and second mortgage notes had been retired] * * *.

"(1) An amount in cash sufficient to redeem at the redemption price hereinabove provided 3,000 shares of preferred stock; and

"(2) An amount in cash sufficient to redeem an aggregate par value of shares of preferred stock (to the nearest full share) equal to one-half of the net income of the corporation for the above twelve months' period, determined as hereinafter provided.

* * * * *

"For the purposes of this paragraph (D) the term 'net income' shall mean [operating revenue, less operating expenses and dividends on preferred stock, and plus or minus nonoperating income or nonoperating loss] * * *."

Petitioner's attorney advised the Transport Company in a letter dated December 30, 1952, as follows:

> "6. The 30,000 shares of Preferred Stock, a temporory certificate for which has been delivered to you today, are validly issued, fully paid and non-assessable. * * *"

The preferred stock was entered on petitioner's books in an account entitled "Preferred Stock." In its annual reports the stock was referred to as preferred stock.

Applications were filed with the Public Service Commission and the Securities Exchange Commission for authority to consummate the transaction, and after various hearings were held, authorization was ultimately obtained. In all proceedings before both of these bodies, the stock in question was always referred to and represented to be preferred stock.

Petitioner, on its tax returns for 1953 and 1954, deducted as "interest" the amount of its payments with respect to the preferred stock, but these deductions were disallowed by the respondent.

The question involved in this issue is whether the security denominated "preferred stock" is a debt or an equity investment. Although there are factors present which favor the taxpayer, the court is of the opinion that there is sufficient support in the record for the tax court's conclusion that the petitioner's payments to preferred stockholders in the years 1953 and 1954 were actually, as well as in form, dividends and not interest and thus nondeductible.

In *Commissioner of Internal Revenue* v. *Meridian & Thirteenth Realty Co.*, 132 F. 2d 182 (7th Cir. 1942), this court made the following statement in a case very similar to the instant one at page 186:

> "It is often said that the essential difference be-

> tween a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event. * * ***

The securities involved in the present case undoubtedly have certain characteristics which would indicate that the investment was not subject to the risks of the venture. For instance, there appears to be a definite maturity date for the stock had to be redeemed by March 1, 1972, at the latest, although an earlier retirement dependent upon the earnings of the corporation was possible. In addition, on the basis of the contract as influenced by Wisconsin corporation law, the redemption price apparently could be paid out of capital or capital surplus and was not dependent on earnings. These factors are persuasive but are not conclusive of the question. *John Kelley Co. v. Commissioner of Internal Revenue*, 326 U. S. 521 (1946); *Commissioner of Internal Revenue v. Meridian & Thirteenth Realty Co., supra;* and *Lee Telephone Co. v. Commissioner of Internal Revenue*, 260 F. 2d 114 (4th Cir. 1958).

As intimated earlier, there are other elements which tend to water down the significance of the above-mentioned factors. The maturity date, for example, is contingent to a certain degree for the preferred stock sinking fund does not commence until after $7,000,000 of bonds and notes are retired. The probabilities are that that these securities will be paid off on schedule, but this is not certain, and, consequently, the maturity date could theoretically be pushed back well beyond the 1972 date.

In addition, the practical effect of such a situation beyond casting a shadow on the definiteness of the maturity date is to subordinate the preferred stock to the debt represented by the bonds and notes. Since, as will be shown later, the preferred stock is also subordinated to

general creditors, it is clear that it is very much subject to the risks of the venture.

Under pertinent Wisconsin statutes[2] it appears that the preferred stock could be redeemed out of funds other than earnings. The redemption is restricted as the redemption can only be made if the corporation would not be rendered insolvent. Thus, it is clear that the preferred stock is in fact subordinated to general creditors.

Another characteristic of the preferred stock which tends to support the conclusion of the tax court is the fact that the charter restricts *current* dividends to earnings. Thus, although deferred cumulative dividends could be paid out of capital surplus at redemption, current dividends are restricted to earnings. Also, there are various provisions on the preferred stock certificate, such as that conferring the right to participate in management upon default, which are typical to any preferred stock.

In addition to the characteristics of the security, the

2. 1951 Wisconsin Statutes—"180.38 *dividends.* • • • (3) The board of directors of a corporation may also, from time to time, distribute to the holders of its outstanding shares having a cumulative preferential right to receive dividends, in discharge of their cumulative dividend rights, dividends payable in cash out of the capital surplus of the corporation, if at the time the corporation has no earned surplus and is not insolvent and would not thereby be rendered insolvent. Each such distribution, when made, shall be identified as a payment of cumulative dividends out of capital surplus."

1951 Wisconsin Statutes—"180.05 *Power of corporation to acquire and dispose of its own shares.* (1) A corporation shall have power to purchase, take, receive, redeem in accordance with their terms, or otherwise acquire, hold, own, pledge, transfer, or otherwise dispose of its own shares; provided that no such acquisition, directly or indirectly, of its own shares for a consideration other than its own shares of equal or subordinate rank shall be made unless all of the following conditions are met:

"(a) At the time of such acquisition the corporation is not and would not thereby be rendered insolvent; • • •"

See also 1953 Wisconsin Statutes, Sections 180.38(3) and 180.385(1)(a).

intent of the parties as derived from the facts and circumstances surrounding the issuance of the stock strongly supports the tax court's decision.

The securities were called preferred stock, were represented to everyone, including various regulatory bodies, as preferred stock, and were carried on the books of the company as preferred stock. Also, the seller's agent testified that it thought it was getting preferred stock, and this fact is of substantial weight for the petitioner insists that the seller devised the *type*, amount, and the basis upon which the securities would be issued.

In *Lee Telephone Co. v. Commissioner of Internal Revenue*, 260 F. 2d 114 (4th Cir. 1958), the court found a security to be an equity investment. Among its comments the court noted at pages 115-116:

> "Perhaps most important of all, the taxpayer, seeking to comply with applicable financial regulations, sought to place a preferred stock issue, to decrease rather than increase, the ratio of its debt to its net worth. The attorney for the taxpayer testified that at the time the taxpayer could have borrowed the money at 3 per cent, but the preferred stock was issued at the higher dividend rate because of the requirement of the regulatory commission. * * *"

The decision of the tax court will be affirmed on this point.

Accounting Method Issue.

During the years 1953 to 1954 the petitioner operated approximately 1,000 vehicles. These vehicles were operated in excess of 33 million miles in each year and carried approximately 281 million passengers in 1953 and 250 million passengers in 1954. In 1953 petitioner's vehicles were involved in 5,903 accidents, and in 1954 there were 5,041 accidents.

Petitioner carried "excess public liability insurance" where liability occasioned by any one accident exceeded $100,000 and was less than $1,000,000, but was a self-insurer where liability was less than $100,000. It maintained a staff of attorneys and claim adjusters to investigate accidents occurring in the course of the operation of its vehicles, to effect settlements, and to defend petitioner in suits brought by parties injured or damaged in such accidents. As of December 31, 1953, there were 414 claims unsettled which had arisen in that year, and as of December 31, 1954, there were 447 unsettled 1954 claims.

The tax court found as fact that:

> "At the end of each of the years 1953 and 1954, petitioner's board of directors appointed from their number, a committee of three (two of whom were attorneys) to examine the information gathered by petitioner's attorneys and claim adjusters relating to each of the unsettled claims, and to determine whether in such committee's opinion petitioner was liable, and to what extent. The committee members were assisted in their work for both taxable years, by the petitioner's general claim agent; and in the first of such years they were assisted also by a certified public accountant from the firm which audited petitioner's books of account."

This committee estimated that the petitioner's liability for the 414 unsettled 1953 claims was $254,659. The estimate for the 447 unsettled 1954 claims was $161,136.50.

The petitioner's general claims agent was in each year authorized to settle the pending claims at the amounts at which they had been appraised, but petitioner did not at any time notify or otherwise admit to any of the claimants that it considered itself liable.

In both years petitioner, an accrual basis taxpayer, set up on its books of account as a book liability for unsettled claims the above-mentioned estimates and also debited a

related expense account for injuries and damages. On its Federal income tax return for 1953, it claimed a deduction of $254,659. In 1954, it claimed a deduction of $142,022.87 which was computed as follows:

Appraised liability on unsettled claims, 1954 accidents		$161,136.50
Deduct: Appraisal liability of 1953 claims settled in 1954	$94,984.00	
Less: Amounts at which 1953 claims were actually settled	75,870.37	19,113.63
Net amount expended and added to liability account		$142,022.87

The respondent, in his statutory notices of deficiency, disallowed the entire amount of $254,659 which was claimed as a deduction on petitioner's 1953 return, and he also disallowed $61,472.79 of the $142,022.87 which was claimed as a deduction on petitioner's 1954 return. The respondent allowed as a deduction in each taxable year the amount of the claims for injuries and damages which actually were settled by the petitioner in each such year.

A substantial number of the unsettled claims for 1953 and 1954 were put into litigation either before or after the close of the taxable year concerned. In all litigated claims the petitioner denied liability in its pleadings. There also was a large number of potential claims which never progressed beyond the point of reports made to petitioner by its employees for the injured parties neither presented claims to petitioner nor filed suit against it.

There were in the two year span 64 claims where the petitioner's committee determined that the petitioner had no liability. Ultimately, however, in 57 of these claims some settlement was made with the claimants.

The tax court further found that:

> "As regards claims wherein the committee had estimated that petitioner was liable and settlements were

made (either with or without litigation), the settlement amounts were equal to the estimates in only 31 out of 261 of such 1953 claims, and in only 22 out of 254 of such claims. Settlements were at variance with estimates by more than 100 percent in 97 of said 1953 claims and in 102 of said 1954 claims."

As of the time of trial, there were still 8 unsettled 1953 claims where liability was currently estimated at $14,500, although the original estimate was $5,200. In addition, there were 13 unsettled 1954 claims currently estimated at $51,415 and originally estimated at $12,750.

The tax court included in its findings the following table which compares petitioner's estimates with its actual experience:

Year	Number of claims	Petitioner's estimated liability	Payments actually made in settlement of same, through Aug. 31, 1958
1953	414	* $254,659.00	$178,230.24
1954	447	** 161,136.50	159,851.84

* Includes $34,470, representing 138 unpressed claims.

** Includes $26,521, representing 144 unpressed claims.

As the tax court stated:

"The question here presented is whether petitioner, an accrual basis taxpayer, may deduct for each of the years 1953 and 1954, certain amounts accrued by it on its books of account as of December 31 of each year. Such amounts represented its estimate of the probable amounts which it would have to pay in settlement for personal injuries and property damages, arising out of accidents in which its employees and equipment were involved."

The tax court decided that the aforementioned estimates were not deductible on two grounds. One such ground was that the unsettled claims did not represent fixed liabilities during the year in which the deduction was claimed because

some claims were being litigated, and as to all other liability was not admitted. In other words, all claims were contested. The other reason was that the amount of liability was not ascertainable with reasonable certainty. This was based on the fact that as to individual claims, the estimates were very often at variance with the actual settlements, settlements were made in many cases where a determination of nonliability had been made, and many claims were in effect only potential claims which were in fact never pressed.

As mentioned above, the petitioner keeps its books on an accrual basis. Section 446 of the 1954 Internal Revenue Code requires the petitioner to compute its income under the method of accounting used in keeping its books unless such method does not clearly reflect income. In the instant case, it is the opinion of the court that petitioner's method of accruing its estimated liability does clearly reflect its income on an annual basis.

In *United States* v. *Anderson*, 269 U. S. 422 (1926), the court, when speaking of the purpose of comparable provisions of the earlier Revenue Code, stated at page 440:

> "* * * It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; * * *."

The reasoning of the court in *United States* v. *Anderson* is equally applicable to the case at bar for there is no question but that the expenses resulting from the various claims are chargeable to the income of the year in which the accident happened. During the trial petitioner produced expert witnesses who testified to the effect that petitioner's procedures were in keeping with generally accepted accounting principles.

While an expense may be logically related to one year or another, it is true that to be deductible as an accrual all events which establish a definite liability in the taxpayer must have occurred during the taxable year, and the amount of such liability must be determinable with reasonable certainty. *Dixie Pine Products Co. v. Commissioner of Internal Revenue*, 320 U. S. 516 (1944); *United States v. Anderson*, 269 U. S. 422 (1926). In the instant case, the court feels that these tests have been met by the petitioner.

The petitioner argues, and rightly so, that all events which determine liability have occurred. The accidents out of which the various claims grow undoubtedly have occurred in the years in question, and the physical facts of the accidents are the only events upon which liability is predicated. Although it is true that the petitioner could not have known the full extent of personal injuries in 1953 or 1954 in any particular case; still this has no bearing on liability itself, but instead is concerned with the question of whether an admitted liability is sufficiently fixed.

In this case then, we have a situation where the operative facts have actually occurred although their meaning or even existence are subject to argument. This is in contrast to the situation where the operative facts have not occurred but are highly predictable. In the latter situation, many businesses prudently set up reserves to protect themselves, but they are not deductible as accrued expenses for although intimately related to the income of the earlier year, the events which fix liability have not happened. This is true even though the future expenses are predictable with great accuracy. *Brown v. Helvering*, 291 U. S. 193 (1934). In the instant case, the expense is related to the income of the earlier year, and the operative facts upon which liability is dependent have occurred.

As mentioned previously, one reason for the tax court's

refusal to allow a deduction in this case was the fact that some claims were being litigated, and liability was not admitted by petitioner as to the rest. Normally it is true that a contested claim is not deductible. *Security Flour Mills Co.* v. *Commissioner of Internal Revenue*, 321 U. S. 281 (1944); *Dixie Pine Products Co.* v. *Commissioner of Internal Revenue*, 320 U. S. 516 (1944); and *Lucas* v. *American Code Co., Inc.*, 280 U. S. 445 (1930).

In all the above-cited cases, there was only a single claim being contested. In such a situation, it is obvious that (1) there may or may not be liability depending on the outcome of the contest, and (2) the amount of the liability is quite often uncertain.

In the present situation there are numerous claims, and assuming at this point that in the aggregate the amount of liability is predictable, neither of the above reasons for not allowing a deduction is pertinent. In the first place, although all claims are contested, this is not a situation where there may or may not be liability, depending on the outcome of the contest. Because of the number of claims, it is apparent to everyone that there is going to be liability, and the only question is in which particular claims this liability will occur. The same line of reasoning applies to the objection that the amount of liability is dependent on the contest. If overall liability can be accurately predicted, there should not be any objection to the fact that it cannot be tied down securely in any particular claim.

In *Ocean Accident & Guarantee Corp., Ltd.*, v. *Commissioner of Internal Revenue*, 47 F. 2d 582 (2d Cir. 1931), a case directly in point, the court stated at page 584:

> "This brings us to the question whether the deduction claimed by petitioner was an 'accrued' loss. It was an aggregate of estimates of policy losses likely to be suffered on account of all accidents or injuries reported to petitioner during the taxable year. As to

> some cases, the petitioner may have admitted liability in the amount of the estimate set up on its record card, and so might come within the terms of Article III of Regulations No. 45 as to a deductible loss under clause (4) of section 234(a). But most of the estimates of liability were not of that character. Each one, viewed alone, would be too contingent as to payment and too uncertain as to amount to be deductible as a 'loss sustained.' *Lucas* v. *Am. Code Co.*, 280 U. S. 445, 50 S. Ct. 202, 203, 74 L. Ed. 538. But the question is whether the aggregate of estimated unpaid losses for any year may not be taken as an aggregate of accrued losses, though each one separately, or at least most of them, would be contingent and unpredictable. The business of insurance presupposes that the insurer is able to treat as accurately computable and predictable an aggregate of variables no one of which is either computable or predictable. Without that the business must fail, and only past experience permits any estimate as to the extent to which the variations caned each other. But the business does go on and with a certainty greater than most others. Here the accrued losses were predictable with remarkable accuracy, the business of petitioner being large enough to disregard the contingencies inherent in each loss taken alone. *To assimilate such a situation to a single loss is, in our opinion, to close one's eyes to the substance of the business.* We do not think the American Code Case so requires. * * * * [Emphasis added.]

The tax court was of the opinion that regardless of the question of a definite fixed liability, the expenses involved in this case could not be estimated with any reasonable certainty. Basically this view was bottomed on the fact that individually the claims were quite difficult to evaluate, and in many cases actual settlement figures differed radically from the estimates made. This view ignores the fact that in the aggregate the unsettled claims are susceptible of reasonably accurate estimation as was recognized in the *Ocean Accident* decision, *supra*.

A comparison of the petitioner's aggregate estimates with actual settlement figures for the years 1953 and 1954 follows:

1953 Estimate—$254,000	
Cost of its cases settled	$178,230.24
Current estimate of unsettled cases	14,500.00
Total	192,730.24
1954 Estimate—$161,130.50	
Cost of 1954 cases settled	$179,851.84
Current estimate of unsettled cases	31,417.00
Total	211,268.84

While it is apparent from these figures that petitioner was not able to estimate its liability with mathematical precision, this need not defeat the deduction for it is only necessary that the estimate be reasonably certain. *Harrold v. Commissioner of Internal Revenue*, 192 F. 2d 1002 (4th Cir. 1951); *Denver Coal Co. v. Commissioner of Internal Revenue*, 271 F. 2d 930 (3rd Cir. 1959); and *Hillsboro v. Commissioner of Internal Revenue*, 237 F. 2d 703 (6th Cir. 1956)

For example, a deduction was allowed in the *Harrold* case although the expense which was estimated at $31,000 was covered by an actual expenditure of only $25,210.18. See also *Patsch v. Commissioner of Internal Revenue*, 208 F. 2d 532 (3rd Cir. 1953), which specifically approved this holding of the *Harrold* decision, and *Denver Coal Co. v. Commissioner of Internal Revenue*, *supra*.

Under the circumstances of this case, the court is of the opinion that a reasonably certain estimate was made with due regard for the actual facts and conditions underlying each claim. The estimates here were made in good faith during the early period of the petitioner's corporate existence, were carefully considered, and can in no way be

equated with the arbitrary figures used by the taxpayer in *Patsch* v. *Commissioner of Internal Revenue*, *supra*. Also of some interest is the fact that when the two years of 1953 and 1954 are considered together, the petitioner's estimates are accurate to within 2.9 percent.

The volume of accidents here involved is substantial. It is probably as substantial as that of a small insurance company. The volume is sufficient so that the overall reserve can be fixed with reasonable accuracy notwithstanding the fact that as to any one case, claim, or potential claim it may not be accurate. With this volume of accidents, the total liability can be predicted with reasonable certainty as to any one year. Where such volume exists, it is the opinion of the court that the taxpayer is justified in following the standard accounting practices for this type of operation. There is no intimation here that the taxpayer was endeavoring to accomplish any illegitimate purpose with reference to the deduction for its estimated liability.

The decision of the tax court is reversed on this point.

A True Copy:
Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit.

UNITED STATES COURT OF APPEALS.

For the Seventh Circuit.

Monday, October 24, 1960.

Before Hon. F. RYAN DUFFY, *Circuit Judge*; Hon. WM G. KNOCH, *Circuit Judge*; Hon. KENNETH P. GRUBB, *District Judge*.

No. 13025.

Milwaukee & Suburban Transport Corporation,
Petitioner,

vs.

Commissioner of Internal Revenue,
Respondent.

PETITION FOR REVIEW OF A DECISION OF THE TAX COURT OF THE UNITED STATES.

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on November 19, 1959, be, and the same is hereby, AFFIRMED on the Preferred Stock issue, and REVERSED on the Accounting Method issue, in accordance with the opinion of this Court filed this day.

A True Copy:
Teste:

KENNETH J. CARRICK,
Clerk of the United States Court of Appeals for the Seventh Circuit.

APPENDIX B.

SUPREME COURT OF THE UNITED STATES.

No. 843 October Term 1960.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
vs.
MILWAUKEE & SUBURBAN TRANSPORT CORPORATION.

ON WRIT OF CERTIORARI to the United States Court of Appeals for the Seventh Circuit.

THIS CAUSE came on to be heard on the transcript of the record from the United States Court of Appeals for the Seventh Circuit, and was duly submitted.

ON CONSIDERATION WHEREOF, It is ordered and adjudged by this Court that the judgment of the said United States Court of Appeals, in this cause, be, and the same is hereby vacated; and that this cause be, and the same is hereby, remanded to the United States Court of Appeals for the Seventh Circuit in the light of *American Automobile Association* v. *United States*, No. 288, October Term, 1960, decided this day, and *United States* v. *Consolidated Edison*

Company of New York, Inc., No. 357, October Term, 1960, decided May 22, 1961.

June 19, 1961.

Mr. Justice Douglas dissents.

A true copy:
Teste:

JAMES R. BROWNING,
Clerk of the Supreme Court of the United States. Certified this nineteenth day of July, 1961.
By R. J. BLANCHARD,
Deputy.

(Endorsed: Filed July 21, 1961. Kenneth J. Carrick, Clerk.)

APPENDIX C.

IN THE UNITED STATES COURT OF APPEALS

For the Seventh Circuit.

No. 13025. September Term and Session, 1960.

MILWAUKEE & SUBURBAN TRANSPORT CORPORATION, *Petitioner,*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*
} On Remand from the Supreme Court of the United States.

September 12, 1961.

Before DUFFY and KNOCH, *Circuit Judges*, and GRUBB, *District Judge*.

GRUBB, *District Judge*. The United States Supreme Court having on June 19, 1961, granted a petition for writ of certiorari covering that part of the decision of this court on the accounting method issue, and having vacated the judgment and remanded the case to this court in light of *American Automobile Association* v. *United States*, 367 U. S. 687 (1961), and *United States* v. *Consolidated Edison Company of New York, Inc.*, 366 U. S. 380 (1961), on the mandate of the Supreme Court and in the light of the consideration of the cases above cited:

It is hereby ordered that the mandate of this Court heretofore issued to the Tax Court of the United States on November 18, 1960, be and the same is hereby recalled, and the judgment entered by this court on October 24, 1960, with reference to the accounting method issue be and it is hereby vacated and that the decision of the tax court on this issue be affirmed.

A true copy:
Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit.

APPENDIX D.

Internal Revenue Code of 1939.

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U. S. C. 1952 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 42.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable

year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U. S. C. 1952 ed., Sec. 43.)

Treasury Regulations 118 (1939 Code):

SEC. 39.41-1. *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See Sections 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 39.41-2. *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See Section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross

income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 39.42-2 and 39.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see section 39.22(c)-5.)

• • • • •

SEC. 39.42-1. *When included in gross income.*—(a) *In general.*—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. See Sections 39.41-1 to 39.41-3, inclusive. • • •

• • • • •

SEC. 39.43-1. "*Paid or incurred*" *and* "*paid or accrued.*" (a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his re-

quest for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

* * * * *

SEC. 39.43-2. *When charges deductible.* Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a growing business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. * * *

Internal Revenue Code of 1954.

Section 162. Trade or Business Expenses. (a) In General. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. * * *

Section 446. General Rule for Methods of Accounting. (a) General Rule. Taxable income shall be computed

under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions. If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) Permissible Methods. Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

Section 461. General Rule for Taxable Year of Deduction. (a) General Rule. The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Treasury Regulations on Income Tax (1954 Code).

§ 1.446-1. General Rule for Methods of Accounting. (a) General rule. (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such overall methods are the cash receipts and disbursements method, an accrual method,

combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. * * *

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment best suited to his needs. However, no method accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

* * * * *

(b) Exceptions. (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

* * * * *

(c) Permissible methods. (1) In general. Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

* * * * *

(ii) Accrual method. Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. * * *

§ 1.461-1. General Rule for Taxable Year of Deduction. (a) General rule—* * * (2) Taxpayer using an accrual method. Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. * * * While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

(3) Other factors which determine when deductions may be taken. (i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

(ii) Where there is a dispute and the entire liability is contested, judgments on account of damages for patent infringement, personal injuries or other causes, or other binding adjudications, including decisions of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting. However, see sub-paragraph (2) of this paragraph. * * *